



[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9600]

RIN 1545-BK04

New Markets Tax Credit Non-Real Estate Investments

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations modifying the new markets tax credit program to facilitate and encourage investments in non-real estate businesses in low-income communities. The final regulations affect taxpayers claiming the new markets tax credit and businesses in low-income communities relying on the program.

DATES: Effective Date: These regulations are effective **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

Applicability Date: For date of applicability see §1.45D-1(h)(4)

FOR FURTHER INFORMATION CONTACT: Julie Hanlon-Bolton, (202) 622-3040 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document amends 26 CFR part 1 to provide additional rules relating to the new markets tax credit under section 45D of the Internal Revenue Code (Code). On June 7, 2011, a notice of proposed rulemaking and notice of public hearing (REG-

101826-11) was published in the **Federal Register** (76 FR 32882). The IRS received comments responding to the notice of proposed rulemaking and held a public hearing on September 29, 2011. After consideration of all the comments, the proposed regulations are adopted as amended by this Treasury decision. The comments are discussed in the preamble.

General Overview

Under section 45D(a)(1), a taxpayer may claim a new markets tax credit on certain credit allowance dates described in section 45D(a)(3) over a 7-year credit period with respect to a qualified equity investment in a qualified community development entity (CDE) described in section 45D(c).

Under section 45D(b)(1), an equity investment in a CDE is a qualified equity investment if, among other requirements: (A) the investment is acquired by the taxpayer at its original issue (directly or through an underwriter) solely in exchange for cash, (B) substantially all of the cash is used by the CDE to make qualified low-income community investments, and (C) the investment is designated for purposes of section 45D by the CDE.

Under section 45D(b)(2), the maximum amount of equity investments issued by a CDE that may be designated by the CDE as qualified equity investments shall not exceed the portion of the new markets tax credit limitation set forth in section 45D(f)(1) that is allocated to the CDE by the Secretary under section 45D(f)(2).

Section 45D(c)(1) provides that a domestic corporation or partnership is a CDE if (A) the primary mission of the entity is serving, or providing investment capital for, low-income communities or low-income persons, (B) the entity maintains accountability to

residents of low-income communities through their representation on any governing board of the entity or on any advisory board to the entity, and (C) the entity is certified by the Secretary as a CDE.

Section 45D(d)(1) defines qualified low-income community investment to mean: (A) any capital or equity investment in, or loan to, any qualified active low-income community business (as defined in section 45D(d)(2)), (B) the purchase from another CDE of any loan made by such entity that is a qualified low-income community investment, (C) financial counseling and other services specified in regulations prescribed by the Secretary to businesses located in, and residents of, low-income communities, and (D) any equity investment in, or loan to, any CDE.

Under section 45D(d)(2)(A), a qualified active low-income community business is any corporation (including a nonprofit corporation) or partnership if for such year, among other requirements, (i) at least 50 percent of the total gross income of the entity is derived from the active conduct of a qualified business within any low-income community, (ii) a substantial portion of the use of the tangible property of the entity (whether owned or leased) is within any low-income community, and (iii) a substantial portion of the services performed for the entity by its employees are performed in any low-income community.

Under section 45D(d)(3), with certain exceptions, a qualified business is any trade or business. The rental to others of real property located in any low-income community is a qualified business only if the property is not residential rental property (as defined in section 168(e)(2)(A)) and there are substantial improvements located on the real property.

Section 1.45D-1(d)(2)(i) requires that a CDE receiving returns on investments (including principal repayments from amortizing loans) must reinvest those proceeds into other qualified low-income community investments during the 7-year credit period. If the proceeds are not reinvested, then the credit may be subject to recapture under section 45D(g)(3)(B).

Many commentators consider the new markets tax credit under section 45D to be a successful tool for encouraging private sector investments in low-income communities. To date, the majority of new markets tax credit investments relate to real estate projects. Real estate projects are well suited to the new markets tax credit program because real estate remains in the low-income community and loans for real estate can extend through the end of the 7-year period in which investors may take the credit on their investment. The 7-year credit period and the reinvestment requirements make it difficult for CDEs to provide working capital and equipment loans to non-real estate businesses because these loans are ordinarily amortizing loans with a term of five years or less. To facilitate investment in non-real estate businesses, the proposed regulations modify the reinvestment requirements for non-real estate projects.

Overview of Proposed Regulations and Summary of Comments

To encourage investments in non-real estate businesses for working capital and equipment, the proposed regulations modify the reinvestment requirements under §1.45D-1(d)(2)(i). The proposed regulations allow a CDE that makes a qualified low-income community investment in a non-real estate business to invest certain returns of capital from those investments in unrelated certified community development financial institutions that are CDEs under section 45D(c)(2)(B) (certified CDFIs) at various points

during the 7-year credit period. The proposed regulations also allow an increasing aggregate amount to be invested in certified CDFIs and treated as continuously invested in a qualified low-income community investment in the later years of the 7-year credit period.

Many commentators welcomed new options for meeting the reinvestment requirements. After considering the comments received, the final regulations adopt the provisions of the proposed regulations with two minor changes based on these comments. In addition to reinvestments in certified CDFIs, the final regulations provide that the Secretary may designate other qualifying entities in the Internal Revenue Bulletin. These final regulations also clarify that investments in non-real estate qualified active low-income community businesses may be made through one or more CDEs. As discussed below, the IRS and the Treasury Department are considering other options for future guidance.

Definition of Non-Real Estate Qualified Active Low-Income Community Business

The proposed regulations define a non-real estate qualified active low-income community business as any business whose predominant business activity (measured by more than 50 percent of the business' gross income) does not include the development (including construction of new facilities and rehabilitation/enhancement of existing facilities), management, or leasing of real estate. The purpose of the investment or loan must not be connected to the development (including construction of new facilities and rehabilitation/enhancement of existing facilities), management, or leasing of real estate.

Commentators requested that the definition of a non-real estate qualified active low-income community business be expanded to include investments connected to the development of owner occupied facilities as long as the facility is used in an operating business. The final regulations do not incorporate this comment because under current regulations, a substantial number of new markets tax credits investments are already being made in owner-occupied facilities. The purpose of these final regulations is to encourage more new markets tax credits investments not related to real estate.

Commentators also requested that if a non-real estate qualified active low-income community business is allowed to use investments for construction or improvements to real estate facilities primarily used in its business, then the definition of working capital under §1.45D-1(d)(4)(i)(E)(2) should include the proceeds of an equity investment or a loan that the non-real estate qualified active low-income community business will expend for the construction of real property within 18 months (as opposed to 12 months) after the date of the investment or loan. The final regulations do not incorporate this comment because the final rules for non-real estate qualified active low-income community businesses do not pertain to investments for construction or improvements to real estate facilities.

In response to comments, the final regulations clarify that an investment in a non-real estate qualified active low-income community business may be made through one or more CDEs. Thus, for example, a CDE that designates an equity investment as a non-real estate qualified equity investment may invest the proceeds in another CDE if that investment is directly traceable to a non-real estate qualified active low-income community business.

Payments of Capital, Equity, or Principal with Respect to a Non-Real Estate Qualified Active Low-Income Community Business

The proposed regulations require that any portion that the CDE chooses to reinvest in a certified CDFI must be reinvested by the CDE no later than 30 days from the date of receipt to be treated as continuously invested in a qualified low-income community investment. Commentators requested that instead of 30 days, CDEs invested in a non-real estate qualified active low-income community business should have 12 months to decide whether to reinvest capital, equity, or principal in another non-real estate qualified active low-income community business or a certified CDFI under §1.45D-1(d)(9)(ii) (similar to the 12-month reinvestment requirement in §1.45D-1(d)(2)(i)). The final regulations do not incorporate this comment because a CDE that has not found a new non-real estate qualified active low-income community business to invest in at the expiration of the 30 day period can invest the capital, equity, or principal in a certified CDFI until it finds a suitable non-real estate qualified active low-income community business. It can then withdraw its investment in the certified CDFI and invest that capital, equity, or principal in the suitable non-real estate qualified active low-income community business.

Commentators also requested that the final regulations allow a CDE that makes an equity investment in a non-real estate qualified active low-income community business to reinvest up to 100 percent of its equity investment in a certified CDFI under §1.45D-1(d)(9)(ii) after the first year of the 7-year credit period. The commentators explained that this would encourage venture capital investments in a non-real estate qualified active low-income community business because liquidity events (cashing out some or all of an investment) occurring early in the 7-year credit period, which often

happen with venture capital investments, would not automatically cause recapture. The final regulations do not incorporate this comment because the proposal could create a situation in which the proceeds of the new markets tax credit investment may only be invested in a qualified active low-income community business for a brief period without any new markets tax credit restrictions on how a certified CDFI may use the proceeds. Such a result would be inconsistent with encouraging investments in qualified active low-income community businesses during the 7-year credit period.

Commentators also requested that the final regulations allow a CDE to invest returns of capital, equity, or principal into entities other than certified CDFIs under §1.45D-1(d)(9)(ii). Such entities would include non-profit and for-profit entities focused on economic and community development, funds that provide equity and loans to small and medium businesses, and funds that provide equity or loans to minority and women owned businesses. The final regulations do not incorporate this comment because it would make administering the final regulations unworkable given the breadth of potential reinvestment vehicles. The final regulations allow investments in certified CDFIs because there are rules that ensure that a certified CDFI serves low-income communities. Such rules do not currently exist for other potential reinvestment entities. However, the final regulations provide that in the future the Secretary may designate other qualifying entities in the Internal Revenue Bulletin. See §601.601(d)(2)(ii)(b).

Section 1.45D-1(d)(9) of the proposed regulations is renumbered as §1.45D-1(d)(10) in the final regulations due to the amendments made by TD 9560 involving targeted populations.

Lines of Credit

A commentator requested that the final regulations consider the entire amount of a line of credit as outstanding loan principal for purposes of the substantially-all requirement under §1.45D-1(c)(5)(i). Lines of credit often serve the capital needs of non-real estate businesses better than fully disbursed loans with fixed terms, which may be more appropriate for real estate investments. The IRS and the Treasury Department are studying these issues and may address them in future guidance.

Other Comments

Other comments were received on issues unrelated to the proposed regulations. The final regulations do not incorporate comments that are outside the scope of the proposed regulations, although they may be relevant to future guidance under the new markets tax credit.

Effective Date/Applicability

The IRS and the Treasury Department received a few comments regarding whether the final regulations should allow a qualified equity investment made before the effective date of the final regulations to be eligible for designation as a non-real estate qualified equity investment. The majority of commentators recommended not adopting a look-back rule because it would be confusing and complicate compliance. After further examination, the IRS and the Treasury Department agree with these commentators. Further, allowing CDEs to designate investments as non-real estate after the investments are made does not serve the purpose of incentivizing new investments in non-real estate projects. Section 1.45D-1(c)(1)(iii) requires that an investment in a non-real estate qualified equity investment must be designated as such for a CDE to qualify for benefits allowed under the final regulations. Accordingly, the

final regulations apply to equity investments made on or after the date the final regulations are published in the **Federal Register**.

Special Analyses

This Treasury decision is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13563. Therefore, a regulatory assessment is not required. Section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking that preceded these final regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business and no comments were received.

Drafting Information

The principal author of these regulations is Julie Hanlon Bolton with the Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1 -- INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.45D-0 is amended by:

1. Adding entries for paragraphs (c)(8), (d)(10), (d)(10)(i), (d)(10)(ii), (d)(10)(ii)(A), (d)(10)(ii)(B), (d)(10)(ii)(C), (d)(10)(ii)(D), and (h)(4).
2. Revising the entry for paragraph (d)(1)(i).

The additions and revisions read as follows:

§1.45D-0 Table of contents.

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(c) * * *

(8) Non-real estate qualified equity investment.

(d) * * *

(1) * * *

(i) Investment in a qualified active low-income community business or a non-real estate qualified active low-income community business.

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(10) Non-real estate qualified active low-income community business.

(i) Definition.

(ii) Payments of, or for, capital, equity or principal with respect to a non-real estate qualified active low-income community business.

(A) In general.

(B) Seventh year of the 7-year credit period.

(C) Amounts received from a qualifying entity.

(D) Definition of qualifying entity.

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(h) * * *

(4) Investments in non-real estate businesses.

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Par. 3. Section 1.45D-1 is amended by:

1. Revising paragraphs (c)(1)(iii), (c)(3)(ii) introductory text, and (d)(1)(i).
2. Amending paragraph (h)(1) by removing the language “paragraph (h)(2)” and adding “paragraphs (h)(2), (h)(3), and (h)(4)” in its place.
3. Adding new paragraphs (c)(8), (d)(10), and (h)(4).

The additions and revisions read as follows:

§1.45D-1 New markets tax credit.

* * * * *

(c) * * *

(1) * * *

(iii) The investment is designated for purposes of section 45D and this section as a qualified equity investment or a non-real estate qualified equity investment (as defined in paragraph (c)(8) of this section) by the CDE on its books and records using any reasonable method.

* * * * *

(3) * * *

(ii) Exceptions. Notwithstanding paragraph (c)(3)(i) of this section, an equity investment in an entity is eligible to be designated as a qualified equity investment or a non-real estate qualified equity investment under paragraph (c)(1)(iii) of this section if--

* * * * *

(8) Non-real estate qualified equity investment. If a qualified equity investment is designated as a non-real estate qualified equity investment under paragraph (c)(1)(iii) of this section, then the qualified equity investment may only satisfy the substantially-all requirement under paragraph (c)(5) of this section if the CDE makes qualified low-income community investments that are directly traceable (including investments made through one or more CDEs) to non-real estate qualified active low-income community businesses (as defined in paragraph (d)(10) of this section). The proceeds of a non-real estate qualified equity investment cannot be used for transactions involving a qualified

active low-income community business that is not a non-real estate qualified active low-income community business.

(d) * * *

(1) * * *

(i) Investment in a qualified active low-income community business or a non-real estate qualified active low-income community business. Any capital or equity investment in, or loan to, any qualified active low-income community business (as defined in paragraph (d)(4) of this section) or any non-real estate qualified active low-income community business (as defined in paragraph (d)(10) of this section).

* * * * *

(10) Non-real estate qualified active low-income community business--(i)
Definition. The term non-real estate qualified active low-income community business means any qualified active low-income community business (as defined in paragraph (d)(4) of this section) whose predominant business activity does not include the development (including construction of new facilities and rehabilitation/enhancement of existing facilities), management, or leasing of real estate. For purposes of the preceding sentence, predominant business activity means a business activity that generates more than 50 percent of the business' gross income. The purpose of the capital or equity investment in, or loan to, the non-real estate qualified active low-income community business must not be connected to the development (including construction of new facilities and rehabilitation/enhancement of existing facilities), management, or leasing of real estate.

(ii) Payments of, or for, capital, equity or principal with respect to a non-real estate qualified active low-income community business--(A) In general. For purposes of paragraph (d)(2)(i) of this section, a portion of the amounts received by a CDE in payment of, or for, capital, equity, or principal with respect to a non-real estate qualified active low-income community business after year one of the 7-year credit period (as defined by paragraph (c)(5)(i) of this section) may be reinvested by the CDE in a qualifying entity (as defined in paragraph (d)(10)(ii)(D)). Any portion that the CDE chooses to reinvest in a qualifying entity must be reinvested by the CDE no later than 30 days from the date of receipt to be treated as continuously invested in a qualified low-income community investment for purposes of paragraph (d)(2)(i) of this section. If the amount reinvested in a qualifying entity exceeds the maximum aggregate portion of the non-real estate qualified equity investment, then the excess will not be treated as invested in a qualified low-income community investment. The maximum aggregate portion of the non-real estate qualified equity investment that may be reinvested into a qualifying entity, which will be treated as continuously invested in a qualified low-income community investment, may not exceed the following percentages of the non-real estate qualified equity investment in the following years:

- (1) 15 percent in Year 2 of the 7-year credit period.
- (2) 30 percent in Year 3 of the 7-year credit period.
- (3) 50 percent in Year 4 of the 7-year credit period.
- (4) 85 percent in Year 5 and Year 6 of the 7-year credit period.

(B) Seventh year of the 7-year credit period. Amounts received by a CDE in payment of, or for, capital, equity, or principal with respect to a non-real estate qualified

active low-income community business (as defined in paragraph (d)(10)(i) of this section) during the seventh year of the 7-year credit period do not have to be reinvested by the CDE in a qualified low-income community investment to be treated as continuously invested in a qualified low-income community investment.

(C) Amounts received from qualifying entity. Except for the seventh year of the 7-year credit period under paragraph (d)(10)(ii)(B) of this section, amounts received from a qualifying entity must be reinvested by the CDE no later than 30 days from the date of receipt to be treated as continuously invested in a qualified low-income community investment.

(D) Definition of qualifying entity. For purposes of paragraphs (d)(10)(ii) and (d)(10)(iii) of this section, a qualifying entity is--

(1) A certified community development financial institution (certified CDFI) that is a CDE under section 45D(c)(2)(B) (as defined by 12 CFR 1805.201), which is unrelated to the CDE making the investment in the certified CDFI within the meaning of section 267(b) or section 707(b)(1); or

(2) An entity designated by the Secretary by publication in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(b) of this chapter).

* * * * *

(h) * * *

(4) Investments in non-real estate businesses. Paragraphs (c)(8) and (d)(10) of this section apply to equity investments in CDEs made on or after **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

Steven T. Miller,
Deputy Commissioner for Services and Enforcement.

Approved: September 21, 2012.

Mark J. Mazur,
Assistant Secretary of the Treasury (Tax Policy).

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